Ketua Pengarah Hasil Dalam Negeri v Cardinal Health Malaysia 211 Sdn Bhd

HIGH COURT (KUALA LUMPUR) — CIVIL APPEAL NO R1–14–12 OF 2009
AZIAH ALI J
22 DECEMBER 2010

Revenue Law — Income tax — Chargeable income — Originating cause — Interest earned from loans granted by local company to another company within same group in Netherlands — Whether interest earned taxable in Malaysia — Whether interest earned income accruing in or derived from Malaysia — Income Tax (Exemption) (No 48) Order 1997 — Income Tax Act 1967 Schedule 6 para 28

The appellant was a company incorporated in Malaysia. During the years of assessment 1999–2005, the appellant carried on the business of manufacturing and exporting latex and synthetic gloves. Allegiance Healthcare Holding BV ('Allegiance Netherlands') was a company organised under the laws of the Netherlands. Both the respondent and Allegiance Netherlands were part of the Cardinal-Allegiance group. Allegiance Netherlands functioned as a financing entity for the group and monitored the cash flow conditions and funding requirements of entities within the group. Surplus funds were channeled from within the group reducing the need for external debt. The respondent and Allegiance Netherlands entered into 'Revolving Credit Agreements' under which the respondent agreed to make advances to Allegiance Netherlands from time to time up to an aggregate amount not exceeding USD50,000,000 at any time. Interest was payable for advances made under this agreements. The respondent made advances to Allegiance Netherlands under the above agreements during the years of assessment 1999 to 2005. The respondent invested surplus funds consisting of profits from its business activity by way of loans to Allegiance Netherlands and in consideration of the loans granted to Allegiance Netherlands the appellant received passive income in the form of interest payments. The funds were maintained in Malaysia and invested abroad within the Cardinal-Allegiance group. The respondent treated the interest income it received from Allegiance Netherlands as tax-exempt on the basis that it is foreign-source income. The appellant on the other hand sought to tax the interest paid by Allegiance Netherlands under the agreements between the respondent and Allegiance Netherlands. The SCIT concluded that the interest income sourced in the Netherlands by the respondent can only be said to be sourced outside Malaysia and accordingly, the receipt of the interest income from Allegiance Netherlands by the respondent in Malaysia was held to be not chargeable to tax by virtue of the Income Tax (Exemption) (No 48) Order 1997

or para 28 of Schedule 6 of the Income Tax Act 1967 ('the Act'). Hence this appeal by the appellant.

Held, dismissing the appeal with costs:

(1) The appellant was seeking to tax based on its contention that 'the originating cause' was the source of funds that was generated from the business activity and from which the loans were made by the respondent to Allegiance Netherlands. However, the funds per se did not produce the interest income (see para 18).

(2) It is the supply or provision of credit, and not the source of the credit, that is the originating cause or source of the interest received by the lender. It was the transaction or activity undertaken by the respondent which was the provision of loans to Allegiance Netherlands that was the originating cause that produced the interest income (see para 18).

(3) Allegiance Netherlands, the recipient of loans from the respondent, had its place of business in The Netherlands. The agreements entered into between the respondent and Allegiance Netherlands and the provision of credit were not made in Malaysia. The respondent lent the monies to Allegiance Netherlands in The Netherlands. Thus the interest income received by the respondent in Malaysia were not income accruing in or derived from Malaysia but it were income derived from sources outside Malaysia. Hence, the SCIT had correctly concluded that the interest income sourced in The Netherlands by the respondent can only be said to be sourced outside Malaysia. Pursuant to para 28 of Schedule 6 of the Act the receipt of interest income in Malaysia by the respondent from Allegiance Netherlands was not chargeable to tax (see para 19).

[Bahasa Malaysia summary

Perayu merupakan syarikat yang diperbadankan di Malaysia. Sepanjang tahun taksiran 1999–2005, perayu menjalankan perniagaan perkilangan dan mengeksport sarung tangan getah dan sintetik. Allegiance Healthcare Holding BV ('Allegiance Netherlands') merupakan syarikat yang tertakluk di bawah undang-undang Netherlands. Responden dan Allegiance Netherlands merupakan sebahagian daripada kumpulan Cardinal-Allegiance. Allegiance Netherlands berfungsi sebagai entiti yang membiayai dan mengawasi keadaan-keadaan aliran tunai dan keperluan-keperluan pembiayaan entiti-entiti di dalam kumpulan tersebut. Lebihan dana yang disalurkan dari dalam kumpulan tersebut mengurangkan keperluan untuk mendapatkan hutang daripada pihak luar. Responden dan Allegiance Netherlands telah memeterai satu 'Perjanjian Pusingan Kredit' di mana responden telah bersetuju untuk memberikan pendahuluan kepada Allegiance Netherlands dari masa ke semasa sehingga jumlah agregat tidak melebihi USD50,000,000 pada satu-satu masa. Faedah harus dibayar bagi pendahuluan yang dibuat di bawah

perjanjian ini. Responden telah membuat pendahuluan kepada Allegiance Netherlands di bawah perjanjian-perjanjian tersebut sepanjang tahun taksiran 1999 hingga 2005. Responden telah melaburkan lebihan dana yang terdiri daripada keuntungan-keuntungan daripada aktiviti perniagaannya dengan cara memberi pinjaman kepada Allegiance Netherlands dan sebagai balasan ke atas pinjaman-pinjaman yang diberikan kepada Allegiance Netherlands, perayu akan menerima pendapatan pasif berbentuk bayaran faedah. Dana-dana tersebut disimpan di Malaysia dan dilaburkan ke luar negara di dalam kumpulan Cardinal-Allegiance. Responden menganggap faedah pendapatan yang diterima daripada Allegiance Netherlands sebagai cukai yang dikecualikan memandangkan ia merupakan sumber pendapatan asing. Perayu menuntut untuk mengenakan cukai ke atas faedah yang dibayar oleh Allegiance Netherlands di bawah perjanjian-perjanjian di antara responden dan Allegiance Netherlands. SCIT menyimpulkan bahawa faedah pendapatan tersebut adalah daripada sumber di Netherlands oleh responden dan didapatkan daripada luar Malaysia dan oleh itu, faedah pendapatan yang diterima daripada Allegiance Netherlands oleh responden diputuskan tidak tertakluk kepada cukai berdasarkan Perintah Cukai Pendapatan (Pengecualian) (No 48) 1997 atau perenggan 28 Jadual 6 Akta Cukai Pendapatan 1967 ('Akta'). Berikut merupakan rayuan oleh perayu.

Diputuskan, menolak rayuan dengan kos:

(1) Perayu menuntut untuk mengenakan cukai berdasarkan hujah 'kausa tindakan' iaitu sumber dana dihasilkan daripada aktiviti perniagaan dan daripada pinjaman-pinjaman yang dibuat oleh responden kepada Allegiance Netherlands. Walau bagaimanapun, dana tersebut dengan sendirinya tidak dapat menghasilkan faedah pendapatan (lihat perenggan 18).

(2) Bekalan atau peruntukan kredit dan bukannya sumber kredit, yang merupakan kausa pemula atau sumber faedah yang diterima oleh peminjam. Transaksi atau aktiviti yang dijalankan oleh responden dengan memperuntukkan pinjaman-pinjaman tersebut kepada Allegiance Netherlands yang merupakan kausa tindakan yang menghasilkan faedah pendapatan (lihat perenggan 18).

(3) Allegiance Netherlands, penerima pinjaman-pinjaman daripada responden, mempunyai alamat perniagaan di Netherlands. Perjanjian-perjanjian yang dimeterai di antara responden dan Allegiance Netherlands dan peruntukan kredit tidak dibuat di Malaysia. Responden meminjamkan wang kepada Allegiance Netherlands di Netherlands. Oleh itu faedah pendapatan yang diterima oleh responden di Malaysia bukan terdiri daripada pendapatan yang dijana dari dalam atau didapatkan di Malaysia tetapi pendapatan tersebut didapatkan melalui sumber-sumber di luar Malaysia. Maka, SCIT telah memutuskan

dengan tepat bahawa faedah pendapatan yang berasal daripada Netherlands oleh responden boleh dikatakan didapati daripada sumber di luar Malaysia. Menurut perenggan 28 Jadual 6 Akta, penerimaan faedah pendapatan di Malaysia daripada Allegiance Netherlands tidak tertakluk kepada cukai (lihat perenggan 19).]

Notes

For a case on chanrgeable income, see 10 *Mallal's Digest* (4th Ed, 2011 Reissue) paras 2462.

Cases referred to

Commissioner of Inland Revenue (NZ) v NV Philip's Gloeilampenfabrieken [1955] NZLR 868 (refd)
Commissioner of Inland Revenue v HK-TVB International Ltd [1992] 2 AC 397 (refd)
Commissioner of Inland Revenue v Hang Seng Bank Ltd [1991] 1 AC 306 (refd)
Commissioner of Inland Revenue v Lever Brothers & Unilever Ltd (1946) 14 SATC 1 (refd)
Commissioner of Inland Revenue v Orion Caribbean Ltd [1997] 2 HKC 449 (refd)
Eisner v Macomber (1919) 252 US 159 (refd)
Nathan v Federal Commissioner of Taxation (1918) 25 CLR 183 (refd)
OA Re Ltd v Ketua Pengarah Hasil Dalam Negeri (1996) MSTC 2,752 (refd)

Legislation referred to

Companies Act 1965
Income Tax Act 1967 ss 3, 91(1), Schedule 6
Income Tax (Exemption) Order 1997

Neng Juliana Ismail (Mohamad Harzani Tahir with her) (Revenue Cousel, Inland Revenue Board) for the appelant.
Elaine Yap (Wong Kae Jeen and Kong Si Ying with her) (Wong & Partners) for the respondent.

Aziah Ali J:

[1] This is an appeal against the decision of the Special Commissioners of Income Tax ('SCIT') dated 19 March 2009 which allowed the appeal by the respondent against the assessments made by the appellant under the Income Tax Act 1967 ('the Act') as follows:

Year of Assessment	Type of Assessment	Date of Notice	Amount (RM)
1999	Additional	11.01.2007	1,989,217.22

2000(CY)	Additional	29.12.2006	1,048,840.13
2001	Additional	29.12.2006	5,563,559.57
2002	Additional	29.12.2006	2,084,062.06
2003	Additional	29.12.2006	1,786,719.87
2004	Original	29.12.2006	683,105.02
2005	Additional	29.12.2006	524,474.50

[2] The issues for determination by the SCIT are as follows:

(a) whether interest income paid to the respondent by Allegiance Healthcare BV during the years of assessment 1999–2005 is tax-exempt foreign source income received in Malaysia by virtue of s 3 of the Act, Income Tax (Exemption)(No 48) Order 1997 and para 28 of Schedule 6 of the Act;

(b) whether the additional assessments raised by the respondent for the years of assessment 1999 and 2000 (current year basis) are time barred under s 91 of the Act; and

(c) whether the respondent has correctly and reasonably imposed penalties on the appellant.

[3] The salient facts found by the SCIT (para 6 of case stated) are as follows:

(a) the appellant is a company incorporated under the Companies Act 1965 and having its registered address at third Floor Wisma Wang, 251-A, Jalan Burma, Georgetown, Penang;

(b) during the years of assessment 1999–2005, the appellant carried on the business of manufacturing and exporting latex and synthetic gloves;

(c) Allegiance Healthcare Holding BV ('Allegiance Netherlands') is a company organised under the laws of the Netherlands having its principal place of business at AHH BV-36051482, Gotlandstraat 38, 7418AX Deventer, The Netherlands;

(d) both the respondent and Allegiance Netherlands are part of the Cardinal-Allegiance group;

(e) Allegiance Netherlands functions as a financing entity for the group and monitors the cash flow conditions and funding requirements of entities within the group. Surplus funds are channeled from within the group reducing the need for external debt. It also serves the purpose of expediting movement of loans wherever needed within the group without having to deal with the long bureaucratic process involved when using third party bankers. The central treasury function within the Cardinal-Allegiance Group enables entities with surplus funds to invest

the same by way of loans to Allegiance Netherlands, which are repayable on commercially competitive rates; (Emphasis added.)

(f) Allegiance Netherlands is designated by the group as one of the central points to receive funds and to function as treasurer for managing surplus funds in the group;

(g) the respondent and Allegiance Netherlands entered into a 'Cross-Revolving Credit Agreement' ('the agreement') which took effect on 22 June 1998 and an amended agreement which took effect on 15 June 2000. Under the amended agreement ('amended agreement') the parties reduced the threshold amount of advances made to each other from an aggregate amount not exceeding USD50,000,000 (under the agreement effective from 22 June 1998) to an aggregate amount not exceeding 118023,300,000 at any time;

(h) interest was payable under both the agreement and the amended agreement;

(i) the respondent and Allegiance Netherlands entered into a 'Revolving Credit Agreement' which took effect on 30 March 1999 ('second agreement') under which the respondent agreed to make advances to Allegiance Netherlands from time to time up to an aggregate amount not exceeding USD50,000,000 at any time. Interest was also payable for advances made under the second agreement;

(j) the respondent and Allegiance Netherlands entered into another 'Revolving Credit Agreement' which took effect on 11 August 2000 ('third agreement') under which the respondent agreed to make advances to Allegiance Netherlands from time to time up to an aggregate amount not exceeding USD50,000,000 at any time. Interest was also payable for such advances made under the third agreement;

(k) the respondent made advances to Allegiance Netherlands under the above agreements during the years of assessment 1999–2005. Full disclosure was made and the transactions were approved by Bank Negara;

(l) the respondent invested surplus funds consisting of profits from its business activity by way of loans to Allegiance Netherlands and in consideration of the loans granted to Allegiance Netherlands the appellant received passive income in the form of interest payments;

(m) the funds were maintained in Malaysia and invested abroad within the Cardinal-Allegiance group;

(n) from the respondent's perspective the loans to Allegiance Netherlands is a simple deposit arrangement where it deposited its surplus funds and obtained interest income on such deposits;

(o) the respondent treated the interest income it received from Allegiance Netherlands as tax-exempt on the basis that it is foreign-source income;

(p) the appellant on the other hand seeks to tax the interest paid by Allegiance Netherlands under the agreements between the respondent and Allegiance Netherlands;

(q) before the audit exercise the appellant accepted the respondent's income as declared for years of assessment 1999 and 2000. Prior to the self-assessment system (in years 1999 and 2000) the appellant had treated and accepted the interest income as foreign source from the respondent's audited accounts;

(r) it was upon audit and a closer examination that the appellant conclude that the interest income was not a foreign source income.

[4] Before the SCIT the appellant contends that:

(a) the interest income paid to the respondent by Allegiance Netherlands is a Malaysian sourced income because —

(i) the originating cause of the interest income are the loans given by the respondent in Malaysia;

(ii) the interest income accrues in and is derived from Malaysia and is therefore subjected to s 3 of the Act and hence taxable;

(iii) being a Malaysian sourced income, the interest income is nit exempted from tax under the Income Tax (Exemption) (No 48) Order 1997 or para 28 of Schedule 6 of the Act which apply to income derived from sources outside Malaysia;

(b) the additional assessment for the year of assessment 1999 was raised on the basis of para 91(3)(b) and no time limit applies whereas the additional assessment for the year of assessment 2000 (current year basis) was raised within the statutory time frame of six years under s 91(1) of the Act;

(c) the appellant has correctly and reasonably imposed penalties on the respondent.

[5] The respondent on the other hand contends as follows:

(a) the interest income arose in the Netherlands and was therefore sourced and derived in the Netherlands and received in Malaysia;

(b) the said interest income is not chargeable to tax by virtue of the Income Tax (Exemption) (No 48) Order 1997 and para 28 of Schedule 6 of the Act;

(c) the additional assessments raised by the appellant for the years of assessment 1999 and 2000 were received by the respondent in 2007 which is beyond six years after the end of the relevant year of assessment;

(d) the penalties imposed on the respondent is erroneous in law as there was no incorrect return by omitting or understating any income, neither was there any incorrect information given in relation to matters affecting the respondent's chargeability to tax.

[6] In making its findings, the SCIT referred to the Privy Council decision in the case of *Commissioner of Inland Revenue v Hang Seng Bank Ltd* [1991] 1 AC 306 wherein Lord Bridge opined:

> *The question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction*. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that *one looks to see what the taxpayer has done to earn the profit in question*. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But *if the profit was earned by* the exploitation of property assets as by letting property, *lending money* or dealing in commodities or securities by buying and reselling at a profit, *the profit will have arisen in or derived from the place where* the property was let, *the money was* lent or the contracts of purchase and sale were effected (Emphasis added.)

[7] The SCIT further referred to the Privy Council decision in *Commissioner of Inland Revenue v Orion Caribbean Ltd* [1997] 2 HKC 449. In that case Orion Caribbean Ltd ('OCL') a company incorporated in the Cayman Islands was licensed to carry on its business as a deposit-taking company in Hong Kong. OCL was wholly owned by ORPL, a Hong Kong company which was in turn, wholly owned by RBC, a Canadian bank licensed to operate in Hong Kong. OCL functioned as a vehicle for tax avoidance purposes. It regularly borrowed money from ORPL and the Singapore branch of RBC and 'on-lent' it to borrowers thus making a profit out of the interest differential between the borrowings and the lendings. The SCIT referred to that part of the judgment of Lord Nolan referring to a simple case where the taxpayer owns the money that is lent to the borrower as follows:

> If the taxpayer lent its own money to a borrower in, say, New York, then other things being equal there might be little difficulty in saying that the location of the source of the interest on the loan was New York.

The SCIT concluded that the interest income sourced in the Netherlands by the respondent can only be said to be sourced outside Malaysia and accordingly, the receipt of the interest income from Allegiance Netherlands by

the respondent in Malaysia is clearly not chargeable to tax by virtue of the Income Tax (Exemption) (No 48) Order 1997 or para 28 of Schedule 6 of the Act which provides as follows:

SCHEDULE 6

EXEMPTION FROM TAX

[Section 127]

PART I

INCOME WHICH IS EXEMPT

28 (1) Income of any person, other than a resident company carrying on the business of banking, insurance or sea or air transport, for the basis year for a year of assessment derived from sources outside Malaysia and received in Malaysia.

(2) Paragraphs 5 and 6 of Schedule 7A shall apply mutatis mutandis to the amount of income derived and received by a resident company exempted under subparagraph (1).

Accordingly the SCIT allowed the Respondent's appeal. By a deciding order dated 14 July 2009 the SCIT decided as follows:

ADALAH DIPUTUSKAN bahawa pendapatan faedah yang dibayar kepada Perayu oleh Allegiance Healthcare B.V. bagi tahun-tahun taksiran 1999 hingga 2005 adalah merupakan pendapatan daripada sumber di luar Malaysia dan yang diterima dalam Malaysia yang dikecualikan cukai di bawah -

(a) Perintah Cukai Pendapatan (Pengecualian) (No.48) 1997 bagi tahun-tahun taksiran 1999, 2000 (CY), 2001, 2002 dan 2003; dan

(b) Perenggan 28 Jadual 6, Akta Cukai pendapatan 1967 bagi tahun-tahun taksiran 2004 dan 2005.

Being dissatisfied with the said decision, the appellant appeals against the decision of the SCIT. I dismissed the appeal with costs of RM3,000 to the respondent.

SUBMISSIONS

[8] Learned revenue counsel submits that under s 3 of the Act the expression 'accruing in or derived from Malaysia or received in Malaysia from outside Malaysia' gives rise to the concept of source as the basis for taxation within the Act. Section 3 provides as follows:

3 Charge of income tax

Subject and in accordance with this Act, a tax to be known as income tax shall be charged for each year of assessment upon the income of any person accruing in or derived from Malaysia or received in Malaysia from outside Malaysia.

Counsel refers to a decision by the SCIT in *OA Re Ltd v Ketua Pengarah Hasil Dalam Negeri* (1996) MSTC 2,752 wherein with reference to the terms 'accrue' and 'derive' the SCIT having referred to *Black's Law Dictionary* (6th Ed) said:

> In the light of the distinction between both the terms as defined above an income is said to accrue where there comes into existence an unconditional right to receive it. It is said to have been derived when it is received from a specified source. We must add that there must be an accrual of right before there can be a derivation of it.

In that case the SCIT decided that the critical point in determining chargeability under s 3 is that the right to the receipt of the income or the receipt of that income must be from Malaysia. Therefore it is submitted that determining a person's tax liability requires determining the source of the income.

[9] The appellant contends that the interest income received by the respondent is a Malaysian source income. It is submitted that the source of the income is 'capital' and disposal of the source is capital whilst receipt of income is subjected to income tax. The appellant contends that the loan given by the respondent to Allegiance Netherlands is the tree and the interest received from Allegiance Netherlands is the fruit that the tree bears (*Eisner v Macomber* (1919) 252 US 159). The appellant taxed the interest income received by the respondent on the simple reasoning that the source of the interest income ie the 'originating cause' of the interest income is the loan given by the respondent to Allegiance Netherlands. It is submitted that the true source or the 'originating source' for the respondent's interest income is the funds provided for the loans which were garnered from the carrying on of the respondent's business in Malaysia. Thus it is contended that the originating and real source of the interest income is in Malaysia and not a foreign source income. The outgoing payment advice ('exh E') is the evidence in support of the appellant's finding that the origin of the loan is a Malaysian source income and therefore taxable. Learned revenue counsel submits that the decision in *Commissioner of Inland Revenue v Hang Seng Bank Limited* ought to be accepted with caution as on the facts the appeal concerns the taxability of income from trading and there is no indication whether Lord Bridge was focusing on profits of a trading or non trading nature.

[10] For the respondent counsel submits that this is a classic case of a passive placement of funds, analogous to the depositing of private funds by an individual in a foreign financial institution who then receives investment income in the form of interest. Thus this case falls squarely within the factual matrix envisaged by Lord Bridge in the *Hang Seng* case and by Lord Nolan in the *Orion Caribbean* case.

[11] Counsel submits that the SCIT has found that the funds were

transferred and made available to Allegiance Netherlands outside Malaysia and used outside Malaysia by Allegiance Netherlands. Since the place where money was lent is outside Malaysia, therefore the interest derived is likewise outside Malaysia. Counsel submits that if no interest is produced from the respondent's business activities in Malaysia, then it follows that no work was done in Malaysia from which it can be said that a source of interest has arisen. In the present case, the respondent received 'passive income' by letting Allegiance Netherlands the use of its property and this is consistent with the broad guiding principle enunciated by Lord Bridge in the *Hang Seng* case that 'one looks at what the taxpayer has done to earn the profit in question'. Counsel submits that it is wrong to restrict this guiding principle to cases involving trading income only as submitted by learned revenue counsel since Lord Bridge does not make any distinction between trading and non-trading income. Lord Bridge intended to make a distinction between income derived from services rendered and income derived from the use of the taxpayer's property, such as the giving of loans as in this case. It is submitted that the broad guiding principle is to be applied as a starting basis for a wide ranging area or scope to determine source of income. Thus the determination of the source of active business income is different from the determination of source of passive non-business income. For active business income, the source of income is determined from the place where the activity takes place whereas in the case of source of passive income there is no participation in any activity but merely the exploitation of property such as by lending. Therefore it is submitted that in the case of a loan, the interest which is the fruit of the money is derived from where the money is lent. Referring to the case of *Commissioner of Inland Revenue v Lever Brothers & Unilever Limited* (1946) 14 SATC 1 cited by the appellant, counsel submits that following what Watermeyer CJ stated at p 15 that 'it was the making and carrying out of the agreement relating to the [debt] of £11,000,000 by the taxpayer, which earned the income for him', the proper application of the principle is that the source of the interest received by the respondent is the place where the respondent gave the loan/supplied credit to Allegiance Netherlands which is outside Malaysia. It is the operations of Allegiance Netherlands which produced the money out of which payment of interest was made.

DECISION

[12] The facts in *Commissioner of Inland Revenue v Hang Seng Bank Limited*, show that the bank carried on business in Hong Kong in the course of which it acquired amounts of foreign currencies. The bank invested the surplus through overseas banks in the purchase outside Hong Kong of certificates of deposits, bonds and gilt-edged securities, which were sold overseas shortly before maturity on the bank's instructions. The profits from those transactions were included in the bank's assessable profits in the assessments to profit tax. The bank's objection to the assessment were rejected by the commissioner but the

board of review allowed the bank's appeal, holding that those profits did not arise in or derive from Hong Kong and so were not chargeable to tax. The commissioner then appealed to the Privy Council. The sole issue on which the appeal depends is whether the profits earned by the bank through the buying and selling of certificates of deposit in overseas markets were profits 'arising in or derived from' Hong Kong as provided under s 14 of the Inland Revenue Ordinance which provided for profits to be charged for each year of assessment on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits 'arising in or derived from' Hong Kong for that year from such trade, profession or business. Lord Bridge referred to the reasoning of the Board of Review as follows (p 320):

> The income which is the subject of this appeal is the net difference between the price which the bank paid for certificates of deposit, bonds and gilt-edged securities and the price which the bank received when the same were sold. This form of income can only be described as trading income. It is the profit which arose on the resale of assets which had been previously purchased with a view to such resale. *Having identified the nature or source of income it is then necessary to locate the source geographically to see whether it arose in Hong Kong or elsewhere*. Trading income arises where the activities take place from which the income can be said to arise. On the facts of the present appeal it can easily be seen that the income arose outside of Hong Kong. (Emphasis added.)

The Board of Review said further:

> *The source of the income which the commissioner sought to tax is not the source of the funds invested by the bank but the activities of the bank and the property of the bank from which the profits arose*. The moneys received by the bank from customers were converted into totally different property namely certificates of deposits, bonds and gilt-edged securities. The activities of the bank from which the income arose was not the decision making process in Hong Kong or any other activities in Hong Kong. Likewise the income arose from the trading in property situate outside of Hong Kong and not the moneys of customers situate in Hong Kong. (Emphasis added.)

At p 322 the Privy Council said as follows:

> *But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction … The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question*. If he has rendered a sen/ice or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the senfice was rendered or the profit making activity carried on. *But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected* (Emphasis added.)

The Privy Council said 'in Their Lordships' judgment, the decision of the

Board of Review was fully justified by the primary facts and betrayed no error of law'. The Privy Council dismissed the commissioner's appeal and upheld the decision of the Board of Review.

[13] In *Commissioner of Inland Revenue v HK-TVB International Limited* [1992] 2 AC 397, the Privy Council held, inter alia,:

> That in determining the place in which the gross profit from a transaction arose or from which it derived the proper approach was to ascertain *the operations that produced the relevant profits and where they took place.* (Emphasis added.)

Lord Jauncey of Tullichettle referred to the case of *Commissioner of Inland Revenue v Hang Seng Bank Limited* and the judgment of Lord Bridge and said as follows:

> Thus Lord Bridge's guiding principle could properly be expanded to read 'one looks to see what the taxpayer has done to earn the profit in question and where he has done it.
>
> Applying Lord Bridge's guiding principle it is clear that the first question to be determined is what were the transactions which produced the profit to the taxpayer.

[14] Learned revenue counsel submits that it is the respondent's business operations of manufacturing and exporting latex which garnered enough income to create a surplus of funds from which the respondent created the loans. It is submitted that the originating cause of the interest received as income is the work that the respondent does to earn the income, ie the garnering of surplus funds to create the funds for the loans. Therefore the appellant assessed tax based on the source of funds which the appellant submits is the originating cause rather than the transaction or activity that produced the profits.

[15] The basis of the appellant's stand is 'the provision of credit test' and in support learned revenue counsel cited the case of *C of IR v Lever Brothers & Unilever Limited*. In that case Watermeyer CJ said at p 8:

> A series of decisions of this court and of the judicial committee of the Privy Council upon our Income Tax Act and upon similar Acts elsewhere have dealt with the meaning of the 'source' and the inference, which, I think, should be drawn from those decisions is *the source of receipts, received as income, is* not the quarter whence they come, but *the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them*, the quid pro quo which he gives in return for *which he receives them. The work which he does* may be a business which he carries on, or an enterprise which he undertakes, or an activity which he engages and it *may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else*. … let us *compare a loan at interest with a letting of*

property. Clearly the legal aspects of the two contracts correspond very closely. *In each the use of property is given by one party to the other in return for periodical money payments*. There is, of course, one cardinal difference, one is a lease and the other is a mutuum.

In the case of a loan of money the lender gives the money to the borrower, who in return incurs an obligation to repay the same amount of money at some future time and if the loan is one which bears an interest, he also incurs an obligation to pay that interest. … As a rule the lender either gives credit to the borrower or transfers to him certain rights of obtaining credit which had previously belonged to the lender, and *this supply of credit is the service which the lender performs for the borrower, in return for which the borrower pays him interest. Consequently this provision of credit is the originating cause or source of the interest received by the lender*. (Emphasis added.)

[16] In the case of *Commissioner of Inland Revenue (NZ) v NV Philip's Gloeilampenfabrieken* [1955] NZLR 868 which was also cited by the appellant, the respondent was a foreign company incorporated and domiciled in Holland ('the Dutch company') who exported goods to a New Zealand company ('the NZ company') on terms that the NZ company should pay for the same in English sterling currency, in Holland, within three months of the close of the month in which the goods were invoiced and dispatched to New Zealand. There was no provision for payment of interest on any unpaid balances if the credit period expired. Owing to insufficiency of capital the NZ company was owing the Dutch company a sum of £80,000 being balance of unpaid purchase money. The Dutch company was unable to accommodate the request of the NZ company to extend the time for payment due to regulations in force in Holland. The Dutch company agreed to convert the debt into a loan and the two companies entered into an agreement. The Dutch company sent to the NZ company a cheque for £80,000 drawn by the Dutch company upon Midland Bank in London made payable to the order of the NZ company. The NZ company then endorsed the cheque made payable to the Dutch company and returned the cheque to the Dutch company as payment of its debt to the Dutch company. In the NZ company book of accounts the sum of £80,000 was shown as a loan owing to the Dutch company on which it paid interest. The interest paid was deducted each year in its returns of assessable income. The Commissioner of Inland Revenue assessed the NZ company for income tax in respect of the interest received by the NZ company as agent for the Dutch company. The question for consideration was whether the Dutch company could properly be assessed for New Zealand income tax and social security charge, in respect of the interest it received from the NZ company on the loan of £80,000. The court held that the interest which the lender/Dutch company received from the NZ company was not 'income derived directly or indirectly from any other source in New Zealand' … as the actual source of the income was a business transaction, which did not take place in New Zealand, but was carried out in the Netherlands, whereby the credit was made available by way of a loan in the Netherlands in the course of the lender's business in that

country. On the issue of the test for determining the source or derivation of income, the court referred to the test adopted in *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183 wherein Isaacs J said:

> The Legislature in using the word 'source' meant, not a legal concept, but something which a practical man would regard as a real source of income … But the ascertainment of the actual source of a given income is a practical, hard matter of fact.

[17] Thus from the abovementioned authorities it is apparent that what ought to be determined in the present appeal is what the respondent has done to earn the profits and secondly where the profits are derived from. The appellant submits that the true source or the 'originating source' for the respondent's interest income is the funds provided for the loans which were garnered from the carrying on of the respondent's business in Malaysia. The respondent on the other hand submits that it is the loan that the respondent made to Allegiance Netherlands pursuant to the agreements entered into outside Malaysia that produced the income in the form of interest.

[18] Having considered the abovementioned authorities and the submissions of both parties, I agree with counsel for the respondent. It is apparent that the appellant here seeks to tax based on its contention that 'the originating cause' is the source of funds that is generated from the appellant's business activity and from which the loans were made by the respondent to Allegiance Netherlands. However I am of the view that the funds per se do not produce the interest income. In the case of *C of IR v Lever Brothers & Unilever Limited*, Watermeyer CJ said:

> … supply of credit is the service which the lender performs for the borrower, in return for which the borrower pays him interest. Consequently this provision of credit is the originating cause or source of the interest received by the lender.

Therefore it is the supply or provision of credit, and not the source of the credit, that is the originating cause or source of the interest received by the lender. In the present case it is the transaction or activity undertaken by the respondent which is the provision of loans to Allegiance Netherlands that is the originating cause that produced the interest income.

[19] The authorities of *Commissioner of Inland Revenue v Hang Seng Bank Limited* and *Commissioner of Inland Revenue v Orion Caribbean Limited* show that the source of interest on a loan is determined on where the money was lent. In the present case it is not disputed that Allegiance Netherlands, the recipient of loans from the respondent, has its place of business in The Netherlands. The agreements entered into between the respondent and Allegiance Netherlands and the provision of credit were not made in Malaysia. The respondent lent the

monies to Allegiance Netherlands in The Netherlands. Thus the interest income received by the respondent in Malaysia were not income accruing in or derived from Malaysia but it is income derived from sources outside Malaysia. Consequently I find that the SCIT correctly concluded that the interest income sourced in The Netherlands by the respondent can only be said to be sourced outside Malaysia. I find no error in the decision of the SCIT that pursuant to para 28 of Schedule 6 of the Act the receipt of interest income in Malaysia by the respondent from Allegiance Netherlands is not chargeable to tax. For the reasons stated above I dismissed the appeal with costs of RM3,000 to the respondent.

Appeal dismissed with costs.

Reported by Kanesh Sundrum